CPA Now

Calculating Business Damages after the Pandemic

By L. Erik Ringoen, CPA, CFF, ABV, CIRA

The job of financial experts who are hired to estimate individual and business damages (a money award) for matters in dispute is never easy. Add to the regular difficulty the challenges presented by the financial impacts of the COVID-19 pandemic on virtually all businesses, and the endeavor gets very tangled very quickly.

In this blog I provide an overview of the criteria for proving damages, describe the type of matters where business damages arise, discuss the types of damages and the methodologies to calculate damages, and provide examples of how the COVID-19 pandemic may affect a financial expert's lost profit damage calculations.

Lost Profits

Lost profits are typically measured as the difference between the profits the plaintiff would have realized but for the defendant's wrongful act and the profits actually earned. Financial experts are tasked with estimating lost revenue, costs related to lost revenue, and the period of loss – all with reasonable certainty that the amount has been properly calculated. Usually, the loss period is from the date of the wrongful act to the date when the plaintiff returned to the level of profits expected to be earned but for the wrongful act. Depending on the facts and circumstances of each case, the financial expert may calculate losses up to the assessment date and future losses beyond the assessment date.

Damages as a consequence of a wrongful act must be proven to a reasonable degree of certainty. They cannot be speculative and must be reasonably seen as arising naturally from the wrongful act, with actions taken by the plaintiff to mitigate damages. Damages may arise from a party's failure to perform a contractual duty (a contract dispute), from wrongfully interfering with business relationships (tortious interference claim), from disputes among shareholders (shareholder dispute), or from a private wrong resulting from a breach of a standard of care and causing a loss to the injured party (professional negligence claim). There are two types of compensatory damages:

- Expectancy damages – The value of the benefit the plaintiff would have expected to receive if not for the defendant's wrongful act.
- Reliance damages – The damages suffered by the plaintiff for acting in reliance of the defendant failure to fulfill an obligation.[1]

In contract disputes, liquidated damages are stipulated in a contract in which the contracting parties agree to a reasonable estimation of the damages owing one in the event of a breach by the other.

COVID-19 and Calculating Business Damages

Each industry was impacted by the economic turmoil of the pandemic in vastly different ways. Some filed for bankruptcy (Niemen Marcus), while others were temporarily shuttered (Norwegian Cruise Lines). Others, though, may have benefitted, such as the online shopping giant Amazon and other companies that benefitted from the work-at-home economy such as Zoom. Still others were able to efficiently make necessary changes to stay in business, and in some instances establish new revenue streams (Uber Eats).

How a claimant's industry was impacted adds complexity to determining estimates of lost revenue, costs related to lost revenue, and the period of loss with reasonable certainty.

Estimating Lost Revenues

To estimate lost revenues, financial experts commonly rely on methodologies such as the before-and-after approach, yardstick approach, market share approach, an approach based on the terms of a contract, among others based on case-specific facts.

The before-and-after approach compares the plaintiff's revenues before the wrongful act with the actual revenues after the wrongful act. If the wrongful act occurred prior to the COVID-19 pandemic, the historical financial results and forecasts would likely not be reliable. For example, for a real estate group operating six hotels, monthly revenue prior to the COVID-19 pandemic would be significantly higher than monthly revenue during the COVID-19 pandemic. If the real estate group claimed a loss related to a wrongful act prior to the COVID-19 pandemic that caused one of its six hotels to be shut down for several months, measuring lost revenue based on historical data using the before-and-after approach may not be appropriate. The yardstick approach would compare the actual revenue of the shutdown hotel to the actual revenue of the five other hotels not impacted by the wrongful act. It likely would provide a better estimate of loss revenue. In addition, the plaintiff's market share must also be considered as the pandemic could have caused a shrinking of the plaintiff's competitors or possibly competitors being in a better position to capitalize on the pandemic market conditions.

Estimating Costs

Lost profits are generally calculated as lost revenues less avoidable expenses, such as the expenses that would have been incurred but have been avoided because of the lost revenues. Financial experts need to perform a detailed analysis of how fixed costs and variable costs may have decreased or increased because of the wrongful act. It is quite possible these costs were substantially impacted by the COVID-19 pandemic. For example, many businesses incurred additional expenses to meet social distancing and cleaning requirements, extra costs related to purchasing equipment such as laptop computers to allow their workforce to work remotely, or a decrease in payroll expenses following layoffs. Depending on the reason for the change in costs, the lost profit calculation will increase or decrease.

Estimating Period of Loss

Determining when a claimant's lost period is a challenge that will be further complicated by the COVID-19 pandemic. A loss period could be shortened if the claimant's business would not be able to achieve the profitability levels previously attained or lengthened if the wrongful act prevented the business from taking advantage of demand caused by the COVID-19 pandemic. There may be instances in which the plaintiff's business may not return to prepandemic profits. How the claimant's industry was impacted will affect the loss period.

Other Considerations

Historically, an organization's financial planning and analysis (FP&A) function helps identify trends, gain insights, and lay the groundwork for future business decisions. The COVID-19 pandemic, however, revealed the vulnerabilities of traditional FP&A processes and inputs, and brought new challenges. Business leaders want to know what issues others in their industry or sector are experiencing because of the COVID-19 pandemic; they also want to know how their broader ecosystem of partners and related industries and sectors are positioning themselves for the longer term.[2] As a result, the internal and external data collected by FP&A may contain relevant information suitable to lost profit analyses.

Lost profits that include future losses – profits that were expected to be earned after that date of the financial expert's calculation of lost profits – are typically discounted at an appropriate rate that reflects the time value of money. The uncertainties of the COVID-19 pandemic will need to be accounted for when using a market-based discount rate. Financial experts will need to support a rate that accounts for the current risk of a plaintiff's profit stream related to the COVID-19 pandemic.

Conclusion

The economic impact of the COVID-19 pandemic affected businesses differently, some good, some bad, and some still to be determined. Financial experts need to understand the pandemic's impact on specific industries, a company's financial data, and its competitors while still obtaining sufficient relevant and reliable data to support a lost profit calculation. The internal and external data being collected by company's FP&A function could be a good source when calculating lost profits. The economist Paul Samuelson said, "Good questions outrank easy answers." Over the coming months, there will be no easy answers, but as financial experts we will all need to ask good questions.

[1] *AICPA & CIMA Forensic & Valuation Services Practice Aid – Calculating Lost Profits*
[2] *Deloitte,* CFO Insights *(August 2020).*

L. Erik Ringoen, CPA, CFF, CIRA, is a director with Forensic Resolutions Inc., with offices in Westmont, N.J., and Philadelphia. He can be reached at ***eringoen@forensicresolutions.com****.*